

# **Further Changes in the Leverage Ratio of Basel III**

**Andrew Cornford**

**Observatoire de Finance, Geneva**

The new document of the Basel Committee on Banking Supervision on the leverage ratio, has received a qualified welcome from the banking sector but has proved a public-relations disaster amongst much of the broader community of economic and political commentators (Basel Committee on Banking Supervision, 2014). However, the changes in the rules for trade finance, which are part of the revised framework for the leverage ratio, have received a warm welcome from the Director General of the WTO, Roberto Azevedo, who praised their impact on "the availability of trade finance in the developing world where letters of credit are a key instrument of payment" (WTO, 2014).

Critics of the changes have focussed on the way in which the revisions of the earlier consultative document of June 2013 (reviewed in Cornford, 2013) introduce additional complexity into a regulatory indicator whose principal strength was supposed to be its simplicity. Moreover the revisions are widely perceived as concessions to lobbying by the banking sector. Assessment of the effects of the changes in the rules of the leverage ratio is necessarily somewhat speculative and has to rely on less than comprehensive figures coming mainly from the banking sector itself.

Even in the leverage ratio as originally set out in the Basel Committee's document of December 2010 on Basel III (Basel Committee on Banking Supervision, 2010) a bank's exposures to credit risk, which constitute the denominator of the ratio, already included a credit conversion factor of less than 100 per cent for converting one category of off-balance-exposures to their on-balance-sheet equivalents. Such a factor reduces the contribution which the category of exposure makes to the denominator of the leverage ratio, thus facilitating for a bank the process of achieving the target level of 3 percent for the ratio. In the Committee's December 2010 document on Basel III off-balance-sheet commitments which are unconditionally cancellable by the bank at any time without prior notice are multiplied by a credit conversion factor of only 10 per cent to estimate their on-balance sheet equivalent, but such a reduction was not permitted for other off-balance-sheet items.

In its 2011 document on the treatment of trade finance in Basel III (Basel Committee on Banking Supervision, 2011) the Basel Committee did not accept the case for credit conversion factors of less than 100 per cent for estimating the on-balance-sheet equivalents of exposures due to commonly used trade-finance instruments for the denominator of the leverage ratio. The grounds given by the Committee for its refusal were that such instruments are binding commitments for a bank, i.e. commitments which are irrevocable and cannot be cancelled without the agreement of the beneficiary. However, the Committee did say that it might reconsider the case for lower conversion factors on the basis of its monitoring of banks' leverage data during the transition period up to 2017.

In its new document on the leverage ratio the Committee has now moved earlier than previously envisaged, specifying credit conversion factors of less than 100 per cent for trade-related contingencies and transaction-related guarantees. Other changes in the document include taking account of netting for certain securities financing transactions, reduction of a bank's exposure due to derivatives transactions through allowance for cash variation margin as a mitigant of this exposure, revisions in the measurement of exposures due to written

credit derivatives, and the deduction of the cash variation margin exchanged between counterparties to a derivatives transaction from the estimate of the resulting exposure.

The Committee is also intending to monitor the numerator of the leverage ratio during the transition period until 2017. Thus the lower figures for the denominator of the leverage ratio resulting from the changes in the new document may yet be accompanied by a tightening of the definition of capital in the numerator if the Committee views this as justified by the role to be played by the leverage ratio as a regulatory backstop. At present the capital in the numerator includes not only common equity but also other instruments and items meeting conditions as to the capacity to absorb losses and as to their subordination in insolvencies to the rights of depositors, general creditors and holders of subordinated debt. A possible tightening would mean restricting capital to common equity.

In the revised rules of the new document off-balance-sheet commitments - other than liquidity facilities, i.e. commitments to provide liquidity support, related to securitisations which are treated separately as described below - receive credit conversion factors of 20 per cent and 50 per cent according to whether their original maturity is up to or greater than one year. Commitments which are unconditionally cancellable (for example, due to the deterioration of a borrower's creditworthiness) retain their credit conversion factor of 10 per cent.

"Eligible" liquidity facilities now receive credit conversion factors of 50 per cent. Eligibility here is defined in terms of conditions specifying the conditions in which the facility can be drawn, the quality of the assets which it can be used to fund, its seniority in relation to other credit enhancements, and the priority of the repayment of draws under the facility.

Short-term self-liquidating letters of credit associated with the movement of goods in international trade (commitments by the bank to pay which are collateralised by the underlying shipments) receive a contingent conversion factor of 20 per cent in the case of both the issuing bank and the confirming bank (the latter being that which provides a guarantee of payment additional to that of the issuing bank and is usually located in the country of the exporter).

Certain transaction-related contingent items (such as performance bonds, bid bonds, and standby letters of credit, which are vehicles for guaranteeing performance related to particular transactions) now have a credit conversion factor of 50 per cent.

Thus, presumably in the interests of consistency, rather than treating trade finance as a deserving special case, the Committee has decided to accord reduced credit conversion factors to the generic off-balance-sheet commitments of which the trade-finance instruments are a special, though probably the major, case.

Exposures to securities financing transactions can now be reduced in certain cases through netting (offsetting positive and negative exposures to a given counterparty). Securities financing transactions here refer mostly to short-term secured financing through such instruments as repurchase agreements or lending on margin to securities buyers (an arrangement under which the buyers put up a certain margin of the prices of the securities and the bank lends the rest). The permitted allowance for netting depends on the fulfilment of conditions as to the automatic amalgamation of the obligations of the bank towards and from its counterparties and as to legal enforceability. This revision brings the approach to netting of the Basel Committee closer to that of the United States, whose Generally Agreed Accounting Principles (GAAP) allow netting for accounting purposes of certain transactions

unlike the International Financial Reporting Standards (IFRS) that are increasingly used elsewhere.

In the treatment of derivative exposures in the denominator of the leverage ratio, subject to conditions related to the bank's operative accounting framework, the cash portion of the variation margin may be used to reduce the exposures. This margin which is required from a trader in the form of cash or traded securities is designed to reduce potential losses in the event that the trader defaults. It thus may be viewed as a partial guarantee of the trader's performance or alternatively in the words of the Basel Committee's document "as a form of pre-settlement payment".

In the case of written credit derivatives, i.e. where the bank is in the role of the seller, the document of the Basel Committee includes changes designed to bring exposures more into line with that of cash instruments such as loans and bonds, for which a credit derivative can be considered as serving as a synthetic substitute but with a different distribution between buyers and sellers of the risks of gains and losses. This change may involve increases or decreases in the value of the exposure to be included in the denominator of the leverage ratio.

The exposure due to written credit derivatives may be capped as a result of flexibility accorded to banks regarding the exclusion of that part of the measure designed to cover potential future exposure over the life of the contract. This is because potential future exposure may already be included in the derivative's replacement cost, which is the other constituent of the measure of derivatives exposure for the leverage ratio.

A bank's exposure is now also reduced where it provides clearing services for a client's derivative transactions through a central counterparty (CCP) of which the bank is a clearing member but where it does not guarantee the performance of the CCP. (A CCP is an entity that interposes itself between counterparties traded in one or more markets, becoming the buyer to every seller and the seller to every buyer to ensure the completion of transactions if a counterparty defaults.)

How should the revisions to the leverage ratio be assessed and what lessons can be drawn ?

The most eye-catching of the changes – and that which is most easily understood – is the setting of new and lower credit conversion factors for off-balance-sheet commitments due to trade transactions. The possibility that such a change would eventually be made had already been flagged by the Committee itself in its earlier document on trade finance (Basel Committee, 2011), and the new rules for the leverage ratio merely bring forward the date of the change. Earlier the trade-finance sector had been dilatory over making the case that trade-finance transactions entailed very low credit risk. However, batches of data for 2005-2010 assembled by the International Chamber of Commerce and the Asian Development Bank have recently confirmed the low credit risk.

Now that the work of the Basel Committee attracts much more widespread attention owing to the key role which it has been accorded in the post-crisis reform agenda, it could facilitate understanding of its often esoteric proposals by providing fuller accounts, where possible supported by data, of the reasons for its positions on the subjects which it covers. An appropriate vehicle for this might be its Working Paper series in which the Committee already provides useful background on concepts which are important in its work.

As things stand with respect to the present document, for estimates of the impact of the revisions of the rules commentators must depend on fragmentary direct and indirect

information from the sector itself or national regulators. For example, according to Deutsche Bank “for an average top ten bank, if there is such a thing, we think that the proposals could save up to \$100 billion versus previous proposals, or 20 to 30 basis points on the leverage ratio” (Piggott, 2014). (The basis points in this statement presumably refer to the saving of capital in the numerator of the leverage ratio.) From estimates made by Credit Suisse and the United States Federal Deposit Insurance Corporation it is also known that there are big differences between the size of the balance sheets of major United States banks according to whether they are measured under GAAP or IFRS rules – differences amounting to tens of billions of dollars, though the differences have narrowed between 2010 and 2013 (Alexander, 2014). A significant part of these differences must be due to the more liberal treatment of netting under GAAP than under IFRS. As already described, more liberal treatment of netting entails lower exposures in the denominator of the leverage ratio.

Another question – also bearing on complexity– relates to the appropriateness of the level of detail of many of the rules of Basel III enunciated by the Basel Committee, including those for the leverage ratio. Proponents of a high level of detail argue that it is necessary to prevent regulatory arbitrage, i.e. a process in which banks make decisions as to where they locate entities and certain categories of transaction on the basis of the strictness and comprehensiveness of jurisdictions’ regulatory rules. This is a variant of the argument about “the level playing field” for competition between banks which was one of the original policy objectives of the Basel capital framework.

The problem with this argument is that the Basel capital framework has always also been intended as a set of regulatory minima rather than a uniformly applicable regulatory regime. This provides scope for adjustments in the way in which the rules are introduced by governments and regulators at the national level, and the Basel Committee itself has always appeared to favour such adjustments so long as they are in the direction of greater stringency. The role of the Basel capital framework as regulatory minima and the flexibility afforded to regulators by the multiple options as to the setting of capital requirements have facilitated the introduction in emerging-market and other developing countries of capital regulations based on this framework.

As is evident from the commentary above, debate regarding the new rules for the leverage ratio has largely focussed on detailed changes. Arguably this debate has diverted attention from what many would consider to be a more important issue, namely that at 3 per cent the ratio is too low and thus that the amount of capital in the numerator should be increased.

Interestingly the United States may already be moving in this direction. In recent testimony before the Senate Committee on Banking, Housing, and Urban Affairs Daniel Tarullo, the point member of the Board of Governors of the Federal Reserve System for financial regulation, noted that the Federal Reserve and the country’s other banking regulators have proposed an increase in the leverage ratio to at least 5 per cent for global systematically important banks based in the United States.

Many would argue that even the level of the leverage ratio in the proposal described by Tarullo is too low. Thomas Hoenig, a director of the Federal Deposit Insurance Corporation in the United States, has drawn attention to the fact that historically the ratio of tangible equity (equity without various special add-ons) to tangible assets varied between 13 and 16 per cent (Hoenig, 2012). Support for a much higher leverage ratio has also been coming from prominent academics. In a much cited 2013 book Anat Admati, a Professor at Stanford University, and Martin Hellwig, director at the Max Planck Institute Institute for Research on Collective Goods, have described 3 per cent for the leverage ratio as much too low (“If this

number looks outrageously low, it is because the number is outrageously low”) (Admati and Hellwig, 2013: 177).

These criticisms suggest that further changes in the leverage ratio in an upward direction are likely, though probably initially in national regimes rather than in the rules of Basel III. Moreover, appropriately, the level of the ratio rather than the detailed measurement of exposures in its denominator will be the principal focus of future discussion.

## References

Admati A and Hellwig M (2013), *The Bankers New Clothes What's wrong with Banking and What to Do about It*, Princeton and Oxford, Princeton University Press.

Alexander P (2014), “US banks closing the GAAP”, *The Banker*, February.]

Basel Committee on Banking Supervision (2010), *Basel III: A global regulatory framework for more resilient banks and banking systems*, December.

Basel Committee on Banking Supervision (2011), *Treatment of trade finance under the Basel capital framework*, October.

Basel Committee on Banking Supervision (2014), *Basel III leverage ratio framework and disclosure requirements*, January

Cornford AJ (2013), More Details from the Basel Committee Concerning the Basel III Leverage Ratio, *networkideas*, July.

Hoenig T (2012), “Back to Basics: A Better Alternative to Basel Capital Rules”, address to the American Banker Regulatory Symposium, Washington, D.C., September.

Piggott C (2014), “Basel Committee loosens leverage ratio”, *Global Risk Regulator*, February,

WTO (2014) News Item, 17 January.